WEEKLY ECONOMIC INSIGHTS

18 JULY 2016

OUR HIGHLIGHTS:

- **Our outlook of the week: Emerging-market GDP growth is stabilising**
  - China has benefited from its use of debt, but the marginal return is now diminishing.
  - In a low interest-rate environment, emerging-market debt is compensating investors for underlying risk.
- **Our research focus: U.S. industrial production**
  - Industrial production in the United States was up 0.6% in June, an encouraging sign.
  - Further data will be required, however, before this can be considered an uptrend.
  - Industrial production could find support in rising oil prices.

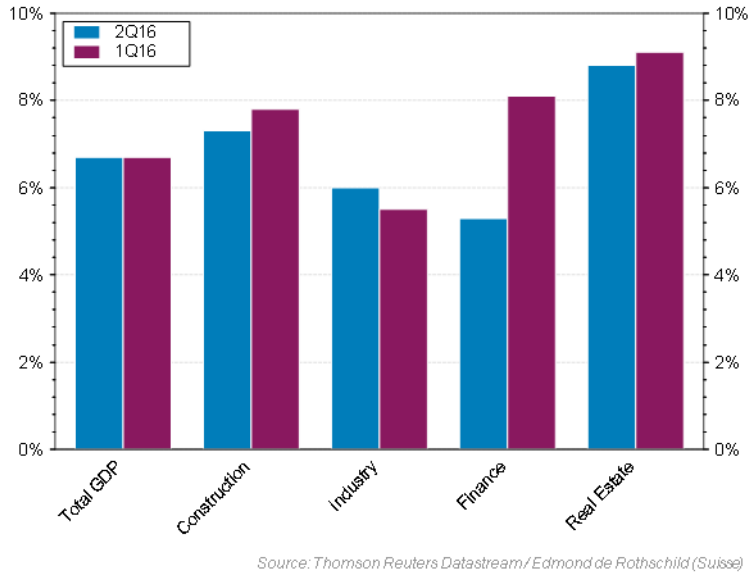
OUR OUTLOOK OF THE WEEK: EMERGING-MARKET GDP GROWTH IS STABILISING

By François Léonet, Economist, Emerging countries, f.leonet@edr.com

China's GDP figures for the second quarter show that **economic activity is levelling off at 6.7%, the same as last quarter. They are also a reminder of the government's focus on the construction sector (+7.3%) and property market (+8.8%)** in its stimulus programme. Growth in financial services was weaker (+5.3%), but this was not a surprise, as financial intermediation returned to earth after being buoyed by the soaring stock market in the first half of 2015 (see chart on the next page).

We believe that the Chinese economy is headed for a soft landing this year. These quarterly figures back our view, even though they are slightly ahead of our projections. The difference stems from the government's support for the property market and infrastructure spending. We have adapted by raising our full-year growth forecast from 6.4% to 6.5%.

China: Real GDP growth (year on year)



All in all, these results are good news for investors and for the Chinese economy. **Yet they also show that the government's extensive stimulus measures have only had a limited impact**. Ongoing production overcapacity is probably discouraging spending by private companies, with the massive injection of credit translating into less and less capital spending.

This situation, which is also linked to bad debt in the Chinese banking system, will have to be addressed by structural reforms sooner or later. The government's readiness to let state-owned manufacturers default on their payments shows that its financial support is neither unlimited nor unconditional. But a coherent action plan will be needed to help state-owned companies figure out how to turn a profit.

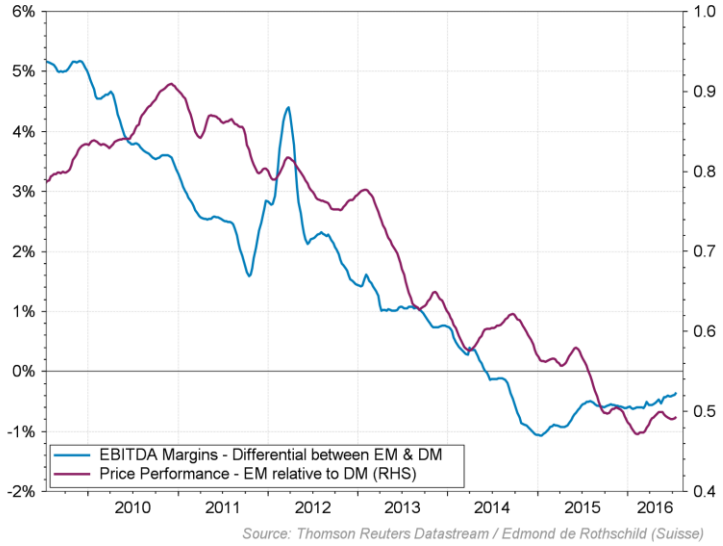
In the next few months, **the government is likely to scale back its stimulus programme**. Financial services have shored up since early 2015, and this should help offset a likely correction in the property market following the recent flare-up in prices that sparked a response from the government. With the debt component of the government's stimulus effort losing its punch, 2017 promises to be a turbulent year, and the official growth target of 6.5% is rather ambitious.

The growth outlook among emerging markets has improved in recent weeks. The rise in commodity prices has boosted major exporting countries, growth in China is stabilising, and global liquidity is abundant and set to remain so. **But emerging markets are headed towards a period of economic stabilisation rather than a real jump in growth. Economic activity is being held in check by problems at the domestic level,** such as a continued decline in productivity, weak trade among emerging-market countries and excessive debt levels.

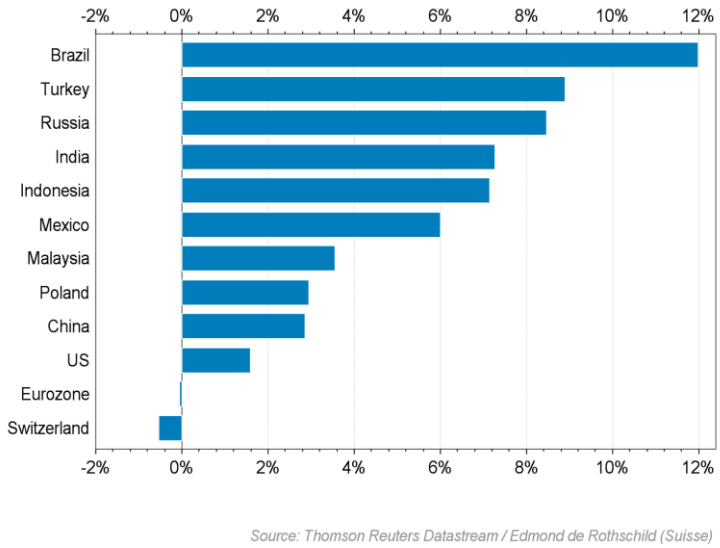
This is not the kind of environment in which emerging-market shares are likely to outperform (see left-hand chart). On the other hand, the major central banks in developed countries are keen on further monetary expansion, which implies low interest rates and plentiful liquidity. **This reflationary policy, together with**

the increasingly firm growth outlook among emerging markets and a pullback in investors' risk aversion, bodes well for emerging-market bonds.

Lower margins undercut share price performance



10 year sovereign bond yields

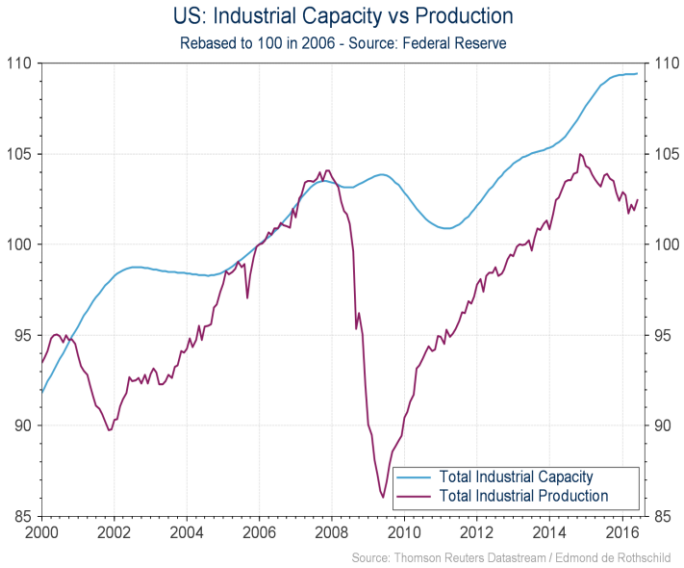


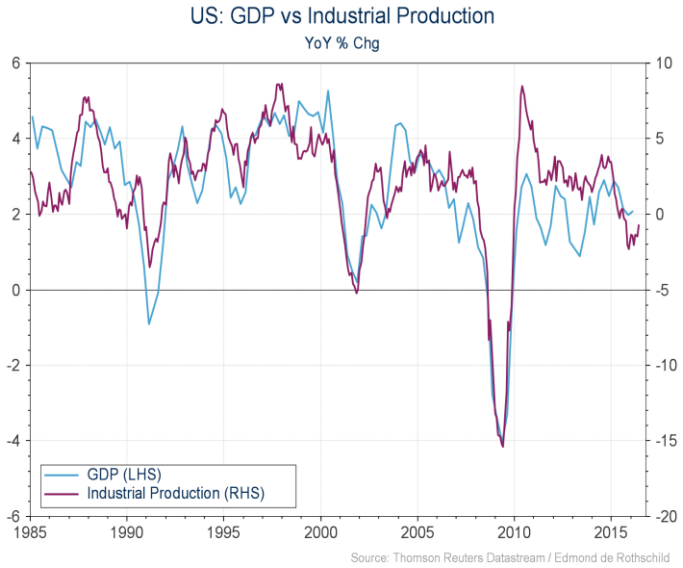
EM bonds also compare favourably to their developed-market brethren in terms of compensating risk. They now offer a viable alternative to the low yields seen in developed countries, where negative interest rates are becoming more common (see right-hand chart above).

OUR RESEARCH FOCUS: U.S. INDUSTRIAL PRODUCTION

By Lisa Turk, Economist, US, l.turk@edr.com

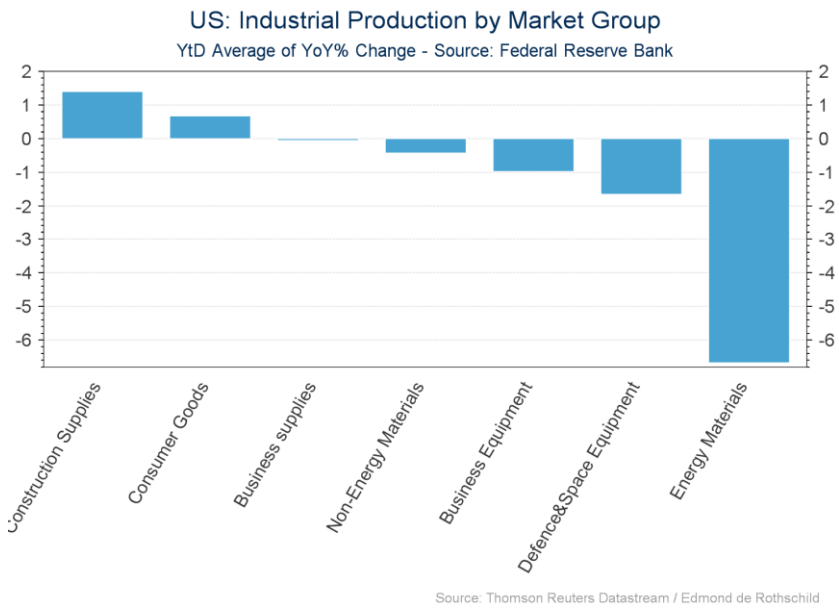
Industrial production in the United States has been holding steady for the past few months (see left-hand chart on the next page). **The latest figures are encouraging, with a 0.6% improvement in June, but it is too early to treat this as an uptrend.** Industrial production currently accounts for 19% of U.S. GDP and is a good leading indicator of the economic cycle (see right-hand chart on the next page). It is particularly useful in identifying when the economy turns a corner and starts expanding or, alternatively, contracting.





When industrial production dropped sharply at the end of 2015 and in early 2016, investors saw this as a possible sign of recession. But the slowdown was really caused by the collapse in oil prices and energy production. This explained the poor industrial production figures and provided reassurance that the rest of the economy would not be affected. Indeed, the economy continued to be powered by the services sector, itself buoyed by high consumer spending.

The breakdown of industrial production by market group is a fair reflection of the strengths and weaknesses of the US economy:



- **Construction supplies** (see the chart on the previous page) **has expanded by an average of 1.4% year on year since the start of 2016**, in step with growth in the property sector over the same period. This group only accounts for 5% of total industrial production, however.

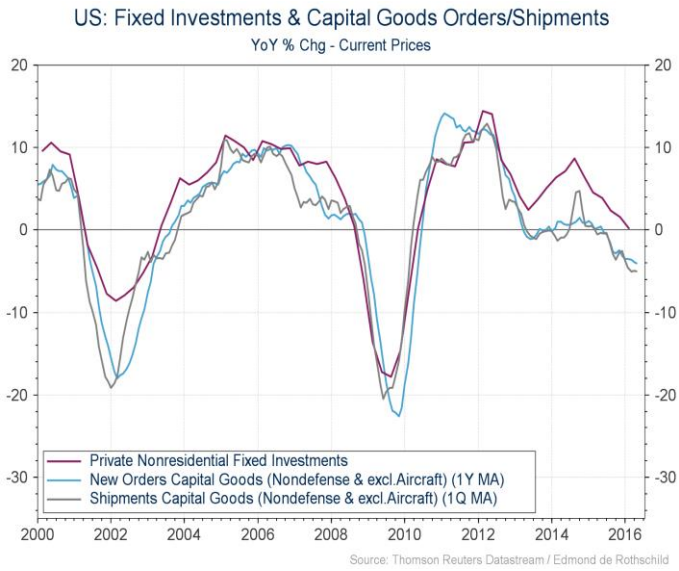
- **Consumer goods** (see chart), which includes automobiles, electronics and food and represents 30% of total industrial production, **has been expanding at an average pace of** 0.68% year on year **since the start of 2016**. Automobile manufacturing (+7.4%) has been particularly strong. Again, these figures are in line with solid consumer spending, which is driving domestic growth.

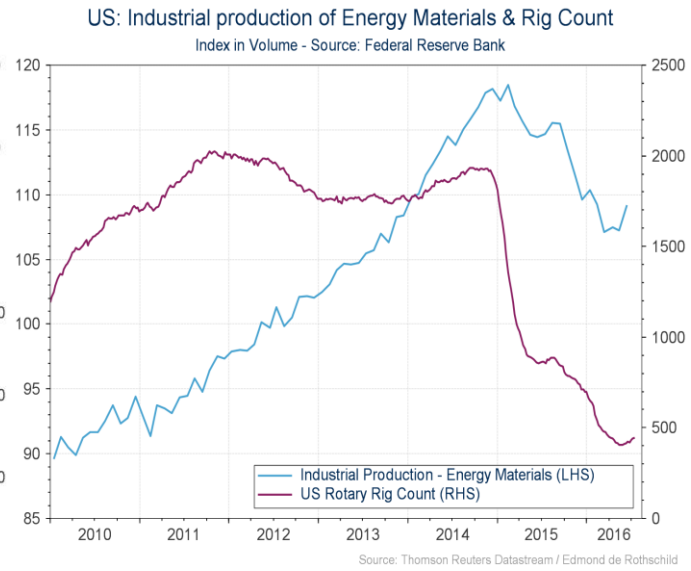
- **On the other hand, business equipment and defence & space equipment – 14% of total production – have struggled in 2016** (see chart). This is mainly due to very low capacity utilisation, around 75.4%. Demand is simply not strong enough to keep companies operating at full productive capacity, and this puts a damper on their need for machines and other capital goods. Weak demand for capital goods is also a result of increased spending by firms on intangible capital, including IT systems, technological progress (the cloud, cyber security), organisational knowledge and R&D. It is hard to quantify spending on intangible capital, but a number of papers published by the Federal Reserve suggest that it is approximately equal to spending on fixed capital.[1]

  With machinery orders down (see left-hand chart on the next page) and exports hurt by the strong dollar, business equipment is likely to bring down overall industrial production figures.

- **Finally, energy materials (including oil and gas) and non-energy materials for intermediate goods are sharply down year on year** (see chart). This owes largely to the pullback in oil production. These two sectors account for 45% of total industrial production and weighed heavily on the overall figures. That said, some companies in the energy sector will ramp up production following the recent rise in oil prices. Initial signs of this are apparent in the latest production figures and rig count (see right-hand chart on the next page).

[1] Corrado, Hulten and Sichel, "Intangible Capital and U.S. Economic Growth", 2009





Conclusion:

- We expect capital spending to grow by only 1.8% on average in 2016 (versus +4.1% in 2015). The impact on orders for capital goods will weigh further on total industrial production.
- Industrial production is more likely to find support in rising (or even stable) energy prices. This, along with the strength of consumer goods and construction supplies, could help push the overall year-on-year figure back into positive territory before the end of 2016.

ECONOMIC FORECASTS

Contributions to global GDP growth

Economic Activity	GDP 2015	GDP 2016 Economist Estimates	GDP 2017 Economist Estimates	Country Weights	Contribution 2016
United States	2.4%	1.9%	2.3%	23.6%	14.2%
Canada	1.2%	1.4%	2.0%	1.9%	0.8%
Euro Area	1.5%	1.5%	1.5%	14.5%	6.9%
Germany	1.5%	1.6%	1.6%	4.2%	2.1%
France	1.1%	1.4%	1.2%	2.9%	1.3%
United Kingdom	2.2%	1.6%	0.9%	3.5%	1.8%
Switzerland	0.8%	1.2%	1.6%	0.7%	0.3%
Russia	-3.7%	-0.8%	1.3%	1.6%	-0.4%
Japan	0.6%	0.5%	0.8%	5.1%	0.8%
China	6.9%	6.5%	6.3%	18.4%	37.9%
India	7.4%	7.5%	7.7%	3.4%	8.2%
Brazil	-3.7%	-3.5%	1.0%	1.9%	-2.1%
Mexico	2.5%	2.4%	2.7%	1.5%	1.2%
Others	3.8%	5.1%	6.3%	16.7%	27.1%
WORLD	3.1%	3.2%	3.5%	100%	100%

Source : Bloomberg Momentum (vs Last Estimates) Performance (Over \ Under)

Comments

- The GDP growth rates shown above are actual for 2015 and projections for 2016 and 2017.
- Each country's weighting is based on its GDP in US dollars as calculated by the World Bank.
- Contributions to global expansion are calculated by multiplying the GDP growth of each country by its weight. The sum of the contributions works out to 3.2% for 2016, a good estimate of this year's global GDP growth.

RETURNS ON FINANCIAL ASSETS

Major benchmarks and currencies

Markets Performances (local currencies)	Last Price	1-Week (%)	1-Month (%)	Year-to-Date (%)	Last Year (%)
Equities					
World (MSCI)	412	1.8%	4.8%	4.9%	-1.8%
United States (S&P 500)	2'164	1.4%	4.8%	7.3%	1.4%
Euro Area (DJ EuroStoxx)	315	2.1%	3.6%	-5.7%	11.2%
United Kingdom (FTSE 100)	6'702	0.2%	11.3%	9.8%	-1.4%
Switzerland (SMI)	8'117	0.5%	6.0%	-4.2%	1.1%
Japan (NIKKEI)	16'723	9.2%	3.7%	-12.5%	11.0%
Emerging (MSCI)	870	2.9%	8.7%	11.4%	-14.6%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.55%	-1.1%	0.3%	6.8%	2.1%
Euro Area (7-10 Yr)	-0.03%	-0.6%	1.6%	6.2%	1.0%
Germany (7-10 Yr)	-0.03%	-0.7%	0.9%	7.1%	0.9%
United Kingdom (7-10 Yr)	0.80%	-0.4%	2.3%	9.2%	0.7%
Switzerland (7-10 Yr)	-0.54%	-0.8%	0.5%	4.3%	3.7%
Japan (7-10 Yr)	-0.22%	-0.4%	0.8%	4.5%	1.4%
Emerging (5-10 Yr)	4.31%	-0.2%	3.5%	11.1%	1.6%
United States (IG Corp.)	2.83%	-0.5%	1.8%	8.4%	-0.8%
Euro Area (IG Corp.)	0.52%	0.3%	1.5%	5.3%	-0.5%
Emerging (IG Corp.)	3.63%	0.0%	2.9%	9.9%	-2.3%
United States (HY Corp.)	6.66%	0.8%	3.5%	12.5%	-3.5%
Euro Area (HY Corp.)	3.63%	0.8%	1.6%	5.1%	0.3%
Emerging (HY Corp.)	7.70%	0.5%	3.1%	14.2%	3.6%
United States (Convert. Barclays)	45	1.1%	4.0%	6.2%	-0.8%
Euro Area (Convert. Exane)	7'193	0.7%	1.0%	-4.1%	7.6%
Real Estate					
World (MSCI)	207	0.7%	5.5%	11.1%	1.0%
United States (MSCI)	222	0.0%	6.0%	12.9%	4.6%
Euro Area (MSCI)	225	0.2%	6.3%	10.9%	16.1%
United Kingdom (FTSE)	6'427	-0.3%	-2.7%	-2.5%	9.4%
Switzerland (DBRB)	3'859	1.0%	2.9%	7.6%	4.6%
Japan (MSCI)	241	6.8%	-0.8%	-9.8%	0.9%
Emerging (MSCI)	104	2.2%	8.4%	6.4%	-6.8%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	541	n.a.	-0.1%	-1.6%	-0.7%
Distressed	727	n.a.	-0.5%	0.0%	-5.3%
Event Driven	578	n.a.	-0.5%	-2.5%	-6.3%
Fixed Income	302	n.a.	-0.5%	-0.2%	0.6%
Global Macro	871	n.a.	0.7%	-1.5%	0.2%
Long/Short	643	n.a.	-1.9%	-5.0%	3.6%
Managed Futures (CTA's)	323	n.a.	4.2%	2.0%	-0.9%
Market Neutral	260	n.a.	-2.5%	-3.5%	1.7%
Multi-Strategy	525	n.a.	-0.1%	0.7%	3.8%
Short Bias	29	n.a.	-1.4%	-7.2%	2.4%
Commodities					
Commodities (CRB)	428	0.3%	0.1%	13.6%	-15.2%
Gold (Troy Ounce)	1'331	-0.1%	3.4%	25.4%	-10.6%
Oil (Brent, Barrel)	46	3.1%	-4.4%	27.7%	-35.9%
Currencies					
USD	97.1	0.7%	3.1%	-1.5%	9.3%
EUR	1.10	-0.5%	-2.7%	1.3%	-10.2%
GBP	1.31	-0.9%	-10.6%	-10.9%	-5.4%
CHF	0.99	0.4%	-2.3%	1.7%	-0.8%
JPY	106.2	-1.4%	-2.1%	13.2%	-0.4%

Source : Bloomberg Momentum (1-week / 1-month / 3-month) Performance (Negative \ Positive)

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EDMOND DE ROTHSCHILD

EDMOND DE ROTHSCHILD (SUISSE) S.A.

Rue de Hesse 18 – 1204 Geneva - T. +41 58 818 91 91
Avenue Agassiz 2 – 1003 Lausanne - T. +41 21 318 88 88
Rue de Morat 11 – 1700 Fribourg - T. +41 26 347 24 24
Beethovenstrasse 9, 8002 Zurich - T. +41 44 818 81 11

www.edmond-de-rothschild.ch